



# CEBS Guidelines for Equity Capital Requirements of Financial Institutions

## Background

The Capital Requirements Directive (“CRD”)<sup>1</sup> implements the provisions of the Basel II capital framework<sup>2</sup> in the European Union (“EU”).

In an attempt to address some of the perceived root causes of the global financial crisis of the last few years, EU lawmakers have conducted a thorough review of the CRD and a series of amending directives have been proposed. The only amendment adopted so far is Directive 2009/111/EC of 16 September 2009 amending the CRD with regard to banks affiliated to central institutions, certain fund items, large exposures, supervisory arrangements, and crisis management (“CRD2”).<sup>3</sup> EU Member States must transpose the changes into their national laws by 31 October 2010 and implement them beginning on 31 December 2010.

Most importantly, the CRD requires credit institutions to hold a minimum level of eligible capital or “own funds” calculated by reference to its risk-weighted exposures, and among other things, CRD2 introduces criteria for the inclusion of instruments in the “original own funds” of a credit institution (e.g., Tier 1 capital).

Specifically, CRD2 has revised the definition of capital under Article 57(a) of the CRD and introduced new criteria under Article 63a for assessing whether certain hybrid capital instruments under Article 57(ca) are eligible to be included in the original own funds of credit institutions and the limits to such inclusion.

Given the important role played by hybrid and other capital instruments in the ongoing capital management of credit institutions (helping to achieve a diversified capital structure and access a wider investor base), it has been important to review the quality of capital being employed by credit institutions. In particular, EU lawmakers concluded that certain instruments treated by credit institutions as “own funds” were not as effective as ordinary shares in absorbing losses during the financial crisis, leading to a focus on the quality of capital relied on as “own funds.” Therefore, EU lawmakers decided to lay down the relevant eligibility criteria for capital instruments being included as original own funds and the limits to inclusion, in order to ensure consistent treatment of such instruments by different national regulators in the EU.

<sup>1</sup> The CRD is comprised of two separate directives: the Banking Consolidation Directive (2006/48/EC), [http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_177/l\\_17720060630en00010200.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en00010200.pdf), and the Capital Adequacy Directive (2006/49/EC), [http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l\\_177/l\\_17720060630en02010255.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_177/l_17720060630en02010255.pdf).

<sup>2</sup> Basel Committee on Banking Supervision (BCBS) document: International convergence of capital measurement and capital standards. A revised framework (Comprehensive version) (June 2006), <http://www.bis.org/publ/bcbs128.pdf?noframes=1>.

<sup>3</sup> Directive 2009/111/EC of 16 September 2009 amending Directive 2006/48/EC, Directive 2006/49/EC and Directive 2007/64/EC with regard to banks affiliated with central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0097:0119:EN:PDF>.

Article 63a(6) of CRD2 mandated the Committee of European Banking Supervisors (“CEBS”) to elaborate on guidelines for the convergence of supervisory practices in relation to (i) the core capital instruments referred to in Article 57(a) (e.g., equity capital) and (ii) the hybrid capital instruments referred to in Article 57(ca).

Accordingly, following public consultation (“CP33”)<sup>4</sup> on 14 June 2010, the CEBS published its final implementation guidelines on instruments referred to in Article 57(a) of CRD (“Article 57(a) Guidelines”).<sup>5</sup> The CEBS also published its feedback document to CP33 which summarised respondents’ comments and discussed key points arising from proposals in CP33<sup>6</sup> and changes made to address them in the final guidelines.

In relation to hybrid instruments referred to in Article 57(ca), the CEBS had already published separate guidelines on 10 December 2009.<sup>7</sup> These guidelines reflected the earlier proposals of the CEBS.<sup>8</sup>

### **Article 57(a)**

CRD2 deleted the wording contained in Article 57(a) of the CRD previously excluding “cumulative preferential shares” and Article 57(a) now reads:

“capital within the meaning of Article 22 of Directive 86/635/EEC, in so far as it has been paid up, plus the related share premium accounts, it fully absorbs losses in going concern situations, and in the event of bankruptcy or liquidation ranks after all other claims.”

Article 22 of Directive 86/635/EEC includes: “all amounts, regardless of their actual designations, which, in accordance with the legal structure of the situation concerned, are regarded under national law as equity capital subscribed by the shareholders or other proprietors.”

Capital instruments which do not comply with all of the criteria under Article 57(a) will only be treated as original own funds if they meet the criteria for hybrid Tier 1 capital set out in Article 57(ca).

### **CEBS Guidelines for Article 57(a) Instruments**

Capital instruments under Article 57(a) form the basis of an institution’s own funds and must have the highest loss-absorption capacity of all capital instruments. The “benchmark” for the Article 57(a) instruments is ordinary share capital.

The CEBS guidelines state that in order for capital instruments to be eligible for Article 57(a) treatment, as with ordinary shares, the instruments must be “simple, clear to understand and able to fully absorb losses in going-concern situations without any doubt and immediately when they arise.”

However, voting rights need not be attached to an instrument for it to be eligible. Such rights are considered irrelevant to the analysis so long as they do not create a privilege for one class over other classes which would have an impact on loss absorbency.

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<sup>4</sup> CEBS Consultation Paper on Implementation Guidelines concerning instruments referred to in Article 57(a) of Directive 2006/48/EC recast (CP33) (17 December 2009), <http://www.c-eps.org/documents/Publications/Consultation-papers/2009/CP33/CP33.aspx> (closed 31 March 2010).

<sup>5</sup> CEBS Implementation Guidelines on Instruments referred to in Article 57(a) of Directive 2006/48/EC Recast (14 June 2010), [http://www.c-eps.org/documents/Publications/Standards---Guidelines/2010/Guidelines\\_article57a/Guidelines\\_article57a.aspx](http://www.c-eps.org/documents/Publications/Standards---Guidelines/2010/Guidelines_article57a/Guidelines_article57a.aspx).

<sup>6</sup> CEBS Feedback Document to CP33 (14 June 2010), [http://www.c-eps.org/documents/Publications/Standards---Guidelines/2010/Guidelines\\_article57a/FS\\_Guidelines\\_article57a.aspx](http://www.c-eps.org/documents/Publications/Standards---Guidelines/2010/Guidelines_article57a/FS_Guidelines_article57a.aspx).

<sup>7</sup> CEBS Implementation Guidelines for Hybrid Capital Instruments (10 December 2009), <http://www.c-eps.org/documents/Publications/Standards---Guidelines/2009/Hybrids/Guidelines.aspx>.

<sup>8</sup> See Morrison & Foerster client alert “What Counts? An Update on the Debate Concerning Regulatory Capital” (13 November 2009), [http://www.mofo.com/files/Uploads/Images/091113Regulatory\\_Capital.pdf](http://www.mofo.com/files/Uploads/Images/091113Regulatory_Capital.pdf).

The Article 57(a) guidelines are divided into four main categories.

1. Definition of capital in the sense of the revised Article 57(a) of the CRD and Recital 4;
2. Permanence;
3. Flexibility of payments; and
4. Loss absorbency,

and the CEBS outlined 10 requisite criteria in relation to these categories.

#### **Definition of capital in the sense of Article 57(a) and Recital 4**

Criterion 1: Subscription to the capital instrument must make the investor a shareholder (or another proprietor), or give the investor a deemed equivalent affiliation under national law. In addition, the instrument must be recognised as equity capital (e.g., not a liability) under the relevant accounting standards and insolvency law.

This criterion is based on Article 22 of Directive 86/635/EEC.

Criterion 2: The capital instrument must be fully paid up. Where the issuer provides any financing to the shareholder (or another proprietor) to facilitate the subscription of capital, either directly or indirectly, the instrument cannot be considered as capital for regulatory purposes. The instrument shall ensure an effective permanent supply of capital.

Circumstances under which the issuer returns capital to its shareholders/proprietors must be closely monitored to prevent any improper distribution of capital.

Criterion 3: The capital instrument must be directly issued (e.g., without using a special purpose vehicle), just as ordinary shares are issued.

#### **Permanence**

The next two criteria were deemed necessary, as redemptions and buy-backs undermine the permanence of the capital instrument.

Criterion 4 (Redemptions): The instrument must be perpetual and must not give the issuer a call option which would entitle it to a redemption outside liquidation (except for discretionary repurchases or other discretionary means of capital reduction permitted under national law). In addition, the shareholder (or another proprietor) shall not have a put option entitling them to require a redemption. Rights under law for shareholders to return their shares to the issuer (such as those that may arise in the context of co-operative or mutual banks) are not considered by the CEBS as put options in this context, where the issuer has the option of rejecting the holder's request. In any case, the relevant national competent authority will be able to refuse permission for any redemption by the issuer of the instrument.

Criterion 5 (Redemptions & buy-backs): Neither the contract nor marketing conditions shall provide any expectation that the capital instrument will be redeemed or bought back. Any redemptions or buy-backs shall be subject to prior approval by the competent authorities based on evaluation by the competent national authority of the institution's Internal Capital Adequacy Assessment Process.

## Flexibility of Payments

The dividends on the instrument should replicate those on ordinary shares. Like any ordinary share, payment of dividends must be fully discretionary.

Criterion 6: The capital instrument must:

- give the issuer full discretion to decide whether to pay a dividend or coupon (or not) and how much dividend/coupon to pay (if any);
- permit the issuer to preserve cash by not paying out dividends/coupons, without triggering an event of default. Non-payment must not be an event of default;
- have no Alternative Coupon Satisfaction Mechanisms which oblige the issuer to substitute the payment of dividend/coupon with payment in kind (e.g., other instruments); and
- have no dividend pushers (which oblige the issuer to pay a dividend/coupon on the instrument if it has paid it on another (e.g., more junior) instrument), or dividend stoppers (which oblige the issuer not to pay dividends on ordinary shares if the dividend on the instrument is not being paid).

Criterion 7: Any dividends must be paid out of distributable items (as defined under national law) and must not be cumulative. The amount or level of distribution must be fully discretionary (i.e., fully flexible) and able to be cancelled permanently and shall not in any way be tied or linked to the amount paid at issuance.

## Loss Absorbency

Criterion 8 (Loss absorbency in a going concern): Recital 4 provides that the instrument must fully absorb losses on a going-concern basis *pari passu* with ordinary shares.” As such, it must take the first share of any losses as they occur (which will be shared *pari passu* with other instruments included under Article 57(a)).

Criterion 9 (Loss absorbency in liquidation): Capital instruments must rank *pari passu* among themselves and have the most subordinated claim in liquidation. They must have no priority in liquidation. Their claim must be limited to the residual assets, in proportion to their share of capital and not to a fixed claim for the nominal amount of their holding.

Criterion 10: The instrument must not be provided with guarantees, pledges or other credit enhancements for the shareholder (or other proprietor) that legally or economically enhance its seniority.

## Next Steps

Member states must transpose the Article 57(a) guidelines into their national legal framework and implement them by no later than 31 December 2010, to coincide with the implementation date for CRD2.

## Transitional arrangements

Recital 5 of CRD2 acknowledges that in order to avoid market disruption and to ensure stable levels of own funds, there should be transitional arrangements for the new regime on capital instruments: “Once recovery is assured, the quality of original own funds should be further enhanced.” The European Commission is mandated to review the application of Articles 57(a) and 57(ca) and to report to Parliament and the Council with suitable proposals “to ensure the quality of own funds” by 31 December 2011.

## Basel III and other global regulatory changes

CEBS has stated, in its feedback document to the CP33, that it is “ready to revisit its guidelines” as necessary “to take into account possible changes in the global regulatory framework.”

While respondents generally supported its objectives, the CEBS reported that many of them expressed concerns that the draft guidelines seemed to go beyond mere interpretations of Article 57(a) and Recital 4 of CRD2 and to inappropriately presage the decision of the Basel Committee on Banking Supervision (“BCBS”), which is currently working on a comprehensive reform of the Basel framework (“Basel III”).<sup>9</sup>

In the meantime, the advantage stated by the CEBS of following the current guidelines is that they will help to ensure consistency with the BCBS’s ongoing work, thereby avoiding instruments not being recognised as core Tier 1 capital when Basel III is implemented.

## Conclusion

At present, the new Basel III rules are expected to be finalised by 31 December 2010 and implemented starting on 1 January 2012, and so further changes later this year to the CRD and/or to the CEBS guidelines for national regulators are quite likely to be needed in order to ensure conformity with Basel III.

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<sup>9</sup> See Morrison & Foerster client alert “More, More, More: A Summary of the Basel Proposals” (2 February 2010), <http://www.mofocom/files/Publication/2f280bc1-1b9a-4d98-929f-0a4554236d0f/Presentation/PublicationAttachment/7cf62184-8f7b-48c4-a4f8-1de08055cfe4/SummaryoftheBaselProposals02022010.pdf>.